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# SEC REPORTING

## SEC Adopts Rules Accelerating Section 16 Reporting

*As a result of the provisions of the recently enacted Sarbanes-Oxley Act, the SEC has adopted rules accelerating the filing deadline for change in ownership reports under Section 16 of the Securities Exchange Act of 1934. The rules also eliminate the ability to delay reporting on transactions between a public company and its directors and officers. These rules will significantly increase both the Section 16 filing burdens for officers and directors, and the potential for late filings. Accordingly, companies must put in place procedures to facilitate timely filing of reports by their directors and officers.*

by Alan Singer

On August 27, 2002, the Securities and Exchange Commission (SEC) adopted rules<sup>1</sup> implementing Section 403 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act),<sup>2</sup> which amended the reporting requirements under Section 16(a) of the Securities Exchange Act of 1934 (Exchange Act). Section 16(a) includes a requirement that officers, directors, and 10 percent shareholders of most domestic public companies<sup>3</sup> file reports of changes in beneficial ownership of the company's equity securities (including the purchase or sale of security-based swap agreements involving such equity securities). Section 403 of the Sarbanes-Oxley Act amended Section 16(a) by requiring that changes in beneficial ownership be reported "before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the [SEC] shall establish, by rule, in any case in which the [SEC] determines that such [two]-day period is not feasible."

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Prior to the effectiveness of the Sarbanes-Oxley Act amendment to Section 16(a), all changes in beneficial ownership resulting from transactions that were not exempt from the short-swing profit provisions of Section 16(b), as well as exercises or conversions of derivative securities (e.g., the exercise of stock options), were required to be reported on Form 4 within 10 days following the month in which the transactions occurred. All other transactions were either reportable on Form 5 up to 45 days following the fiscal year in which the transaction occurred, or were not reportable at all based on exemptions from the reporting requirements under Section 16(a). As a result of the Sarbanes-Oxley Act and the new SEC rules, all transactions formerly reportable on Form 4, as well as all transactions between a company and its directors and executive officers formerly reportable on Form 5, will be subject to accelerated reporting.

## Revisions to Reporting Requirements

The Sarbanes-Oxley Act amendment to Section 16(a), as implemented by the SEC rules, results in the following changes to the prior reporting regimen.

### Reports Filed on Form 4 Prior to the New Rules

Reports filed on Form 4 prior to the new rules will continue to be filed on Form 4, but under the accelerated schedule require a filing no later than two business days following the date of execution of the transaction rather than ten days following the end of the month in which the transaction occurred.<sup>4</sup> For the purposes of the filing, the trade date, not the settlement date, is the date of execution of the transaction.<sup>5</sup> There is a limited exception, discussed later in this article, for transactions that the SEC has concluded meet the conditions for the "not feasible" exception.

### Transactions Reportable on Form 5 Prior to the New Rules

The new reporting scheme may be divided into the following three categories:

1. *Transactions between an issuer and its officers and directors exempt under Rule 16b-3(d) and Rule 16b-3(e).* These include, among others, grants of stock options and stock appreciation rights, awards of restricted stock, and surrender of company stock in payment of tax withholding obligations or in payment of the exercise price of stock options. These transactions are now reportable on Form 4 no later than two business days following the date of the transaction.<sup>6</sup>
2. *Discretionary Transactions exempt under Rule 16b-3(f).* A "Discretionary Transaction" is an employee benefit plan transaction resulting in an intra-plan transaction into or out of a company stock fund or resulting in a cash distribution funded by the disposition of company stock (subject to several exceptions).<sup>7</sup> An extended filing deadline may be applicable to these transactions unless the reporting person has selected the date of transaction execution, in which case the standard two-business day reporting requirement will apply.
3. *All other transactions reportable on Form 5 prior to the new rules.* The few remaining types of transactions reportable on Form 5 (e.g., gifts and certain small acquisitions) will continue to be reportable on an annual basis on Form 5.<sup>8</sup> An acquisition by a reporting person of company equity securities not exceeding \$10,000 in market value and satisfying certain other conditions is still reportable on Form 5, although a transaction between the company and the reporting person must now be reported on Form 4 even if it involves less than \$10,000. If the aggregate amount of other small acquisition transactions during a six month period exceeds \$10,000 or if a disposition occurs within six months after the acquisition, a Form 4 must be filed within two business days following the occurrence of the event that renders the exemption no longer available.<sup>9</sup>

### **Transactions Exempt from Reporting under Section 16(a) Prior to the New Rules**

The SEC did not change the regulations relating to transactions exempt from Section 16 reporting. Therefore, transactions (other than Discretionary Transactions) in a so-called "Tax-Conditioned Plan" will continue to be exempt from reporting.<sup>10</sup> These plans include: (1) a "Qualified Plan" (a plan, e.g., a 401(k) plan, that satisfies the coverage and participation requirements of Section 410 and Section

401(a)(26) of the Internal Revenue Code (IRC) of 1986); (2) a "Stock Purchase Plan" (a plan satisfying the coverage and participation requirements of Section 423(b)(3) and Section 423(b)(5), or Section 410, of the IRC); and (3) an "Excess Benefit Plan" (a plan that is operated in conjunction with a Qualified Plan and provides only the benefits or contributions that would be provided under a Qualified Plan but for any benefit or contribution limitations in the IRC).<sup>11</sup> In addition, stock splits, stock dividends, most dividend or interest reinvestment plans, transactions under domestic relations orders,<sup>12</sup> and other transactions currently exempt from Section 16(a) reporting continue to be exempt.

### **Transactions Now Provided with Special Reporting Deadlines**

In its release adopting the new rules, the SEC noted that the standard two-business day Form 4 filing requirement would not be feasible with respect to "two narrowly defined types of transactions where objective

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criteria prevent the reporting person from controlling the trade date.”<sup>13</sup> The two transactions specifically referenced by the SEC are:

1. *A transaction pursuant to a contract, instruction, or written plan for the purchase or sale of company equity securities that satisfies the affirmative defense conditions of Rule 10b5-1(c) under the Exchange Act (Rule 10b5-1(c) Arrangement), provided that the reporting person does not select the date of transaction execution.* This would include not only so-called Rule 10b5-1 plans, but also a broad class of transactions satisfying the affirmative defense conditions, including transactions under employee benefit plans and dividend or interest reinvestment plans that are not exempt from Section 16 reporting.<sup>14</sup> For these types of transactions, the date of execution is deemed to be the date on which the executing broker, dealer, or plan administrator notifies the reporting person that the transaction has been executed, so long as the notification date is no later than the third business day following the trade date. If the notification is made after the third business day following the trade date, such third business day will be deemed the notification date, and the Form 4 must be filed no later than five business days following the trade date to be considered timely.<sup>15</sup> The SEC stated that “[b]y deeming the notification date to be the third business day following the trade date if actual notification does not occur by then, the rule limits the potential delay permitted for reporting these transactions on a timely basis.”<sup>16</sup>
2. *A Discretionary Transaction, provided that the reporting person does not select the date of transaction execution.* The new rules provide that the date of execution for reporting purposes will be deemed to be the date on which the plan administrator notifies the reporting person that the transaction has been executed. Here again, the three-business day limit applies, so that if the notification date is later than the third business day following the trade date, the date of execution is deemed to be such third business day.<sup>17</sup>

### Potential Form 3 Filing Anomaly

Each person who becomes a director or officer of a company that has a class of equity securities registered under Section 12 of the Exchange Act is required to file an initial report of beneficial ownership on Form 3

within 10 days.<sup>18</sup> Because of the new accelerated filing deadline for Form 4, it is possible that the Form 3 could be filed on a timely basis after a Form 4 is filed. The SEC stated that “[i]n this situation, we encourage the reporting person to file the Form 3 along with the Form 4 at the time the Form 4 is due.”<sup>19</sup> Presumably, where two or more Forms 4 are due before the Form 3, the SEC would prefer that the Form 3 be filed at the time the first Form 4 is filed.

### Amendments to Form 4

The SEC has amended Form 4 by adding a new column to require reporting of the deemed execution date for Rule 10b5-1(c) Arrangements and Discretionary Transactions (a similar change has been made to Form 5).<sup>20</sup> In addition, Form 4 has been modified to reflect that it is no longer a monthly form and that the holdings columns must include holdings following the reported transaction or transactions.<sup>21</sup>

### Treatment of Stock Options

A potentially significant development relating to the reporting of, and potential liability for transactions in, stock options was addressed in the release adopting the new rules. Specifically, the SEC asked for comment on whether “any changes are required in the treatment of stock options under Sections 16(a) and 16(b).”<sup>22</sup> Among the issues raised by the SEC was “whether and how the six-month period of Section 16(b) should be applied and calculated in connection with stock options, exercises, and the sale of the underlying stock.”<sup>23</sup> Among other things, the SEC specifically asked whether a six-month holding period should be required as a mandatory condition to the exemption for stock option grants.

### Coming Attractions

- The regulation of lawyers under the Sarbanes-Oxley Act
- What do securities lawyers need to know about the Commodity Futures Modernization Act?
- Restructuring changes under FAS No. 146

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## Foreign Private Issuers

Rule 3a12-3(b) under the Exchange Act exempts registered securities of foreign private issuers from Section 16 reporting.<sup>24</sup> This exemption remains in effect.

## Electronic Filing of Section 16 Reports

Section 403 of the Sarbanes-Oxley Act requires that, not later than July 30, 2003, all change in ownership reports be filed electronically and be posted on the company's Web site (if it has one) by the end of the business day following the filing. The SEC stated that it is "proceeding expeditiously with rulemaking and related system programming to assure adoption within the one-year period mandated by [the Sarbanes-Oxley Act]."<sup>25</sup> (In fact, SEC Staff representatives have stated that they will seek to have the electronic filing requirements in place well in advance of the July 30, 2003, deadline.) In the meantime, the SEC stated that it will accept electronically filed reports under Section 16(a) "that are not presented in the standard box format and omit the horizontal and vertical lines separating information items, so long as the captions of the items and all required information are presented in the proper order."<sup>26</sup> The SEC also suggested that reporting persons intending to use the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) submit Forms ID requesting EDGAR access codes as soon as possible.<sup>27</sup> This is unfortunate because the administrative burdens involved in having each officer and director of most public companies obtain separate filing numbers for EDGAR filings is formidable. Also, the use of different EDGAR filing numbers by each officer and director increases the possibility of filing errors by companies administering the filing of Section 16 reports. Hopefully, in connection with its system programming efforts, the SEC will undertake significant changes that will make EDGAR more user-friendly for the thousands of persons who will become subject to the electronic filing requirement.

## Proxy Statement Disclosure

The SEC has not changed the requirement that a company disclose late filings of Section 16 reports in its proxy statement.<sup>28</sup> It is likely that proxy disclosures of late or missed filings will become more extensive due to the increase in the number of filings that will

result from the new rules, coupled with the accelerated filing deadlines.

## Status of Related Form 8-K Proposal

On April 12, 2002, the SEC issued a release proposing that companies disclose, on an accelerated basis in Form 8-K, information relating to certain transactions involving their directors and executive officers, including transactions by directors and officers in company equity securities.<sup>29</sup> In light of the Sarbanes-Oxley Act amendments to Section 16(a), the SEC does not intend to consider further Form 8-K disclosure of such transactions in company securities. The SEC stated, however, that it will continue to consider Form 8-K disclosure relating to directors' and executive officers' Rule 10b5-1(c) arrangements and company loans to or guaranties for the benefit of directors and executive officers that are not prohibited by Section 402 of the Sarbanes-Oxley Act.<sup>30</sup> These may be addressed when the SEC considers adoption of its other proposed amendments to Form 8-K.<sup>31</sup>

## Company Actions to Facilitate Compliance

Clearly, the filing burdens under the new rules, coupled with the complexity already embodied in the rules, mandates that companies assume the task of facilitating filings by officers and directors. In order to enhance the ability of directors and officers to comply with the new rules, companies should already have focused on the following actions. In the event that a company has not yet taken these actions, it should do so immediately:

- *Inform directors and officers about the new two-business day filing requirement.* A memorandum is useful, but direct verbal communication will be the most effective means of making sure directors and officers are aware of the new requirements (a memorandum is a useful supplement, however). Remind the officers and directors that transactions by immediate family members sharing the same household, as well as controlled corporations, family partnerships, trusts, and other entities with respect to which the directors and officers are deemed to have a pecuniary interest, are also subject to Section 16 reporting.

- *Require preclearance of all transactions in company securities by directors and officers.* This should be addressed in the communication informing the directors and officers of the two-business day requirement (a board of directors resolution, or resolution of an appropriate board committee, may be helpful in enforcing this requirement).
- *Request assistance from the brokers.* As part of the new procedures, directors and officers should instruct their brokers, in writing, that the brokers must immediately advise the company of any trades they have made.
- *Obtain powers of attorney.* The ability to timely file reports will be enhanced if several company officials are given the power to execute Section 16 reports on behalf of reporting persons.

In addition to the foregoing actions, companies should consider the following, which likely will enhance compliance with the new rules:

- *Provide periodic reminders to directors and officers.* Particularly where directors' or officers' transactions are infrequent, it is important to remind directors and officers not to overlook the filing requirements.
- *Designate more than one person at the company with responsibility for filing Section 16 reports.* If only one person is charged with administering the filing of Section 16 reports and is unavailable, it may not be possible to comply with the accelerated filing deadline. Each responsible person should be designated as an attorney-in-fact for the purpose of signing reports on behalf of officers and directors.
- *Assess compliance and adopt remedial measures, if necessary.* Companies should periodically survey their officers and directors as to transactions they have engaged in. Where non-compliance is discovered, remedial actions should be taken, including, if necessary, suggesting that a director or officer utilize a broker that will advise the company of director or officer transactions on a prompt and complete basis.

## Conclusion

The Sarbanes-Oxley Act and the new SEC rules have resulted in a challenging reporting environment. Proactive oversight by public companies, however,

coupled with effective communications to and from officers, directors, and their brokers, should help to minimize inadvertent violations. Hopefully, in connection with its mandating of electronic filing of Section 16 reports, the SEC will seize the opportunity to simplify the EDGAR filing process, thereby further enhancing the prospects for widespread compliance.

## NOTES

1. Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Release No. 34-46,421, 67 Fed. Reg. 56,462 (Aug. 27, 2002).
2. Pub. L. No. 107-204, 116 Stat. 745.
3. The filing requirements specifically relate to companies that have a class of equity securities registered under Section 12 of the Exchange Act. As noted *infra*, securities registered by a foreign private issuer are exempt from Section 16 reporting.
4. Rule 16a-3(g)(1); Form 4, General Instruction 1(a).
5. Release No. 34-46,421, *supra* Section II.A.
6. Rule 16a-3(g)(1).
7. Rule 16b-3(b)(1).
8. Rule 16a-3(f)(1).
9. Rule 16a-6.
10. Rule 16a-3(f)(1)(B).
11. These plans are defined in Rule 16a-3(b).
12. Rule 16a-9 (stock splits and stock dividends), Rule 16a-11 (dividends and interest reinvestment plans), Rule 16a-12 (domestic relations orders).
13. Release No. 34-46,421.
14. *Id.*
15. Rule 16a-3(g)(2), Rule 16a-3(g)(4). Rule 16a-3(g)(4) under the Exchange Act states that if the notification date is later than the third business day following the trade date of the transaction, the date of execution is deemed to be the third business day following the trade date of the transaction.
16. Release No. 34-46,421.
17. Rule 16a-3(g)(3), Rule 16a-3(g)(4).
18. The Sarbanes-Oxley Act did not amend this requirement, which remains in Section 16(a) under the Exchange Act.
19. Release No. 34-46,421.
20. *Id.*
21. Form 4, General Instruction 1(a) and 4(a)(i). The SEC noted that, "[i]n keeping with current practice, insiders will reflect changes in holdings resulting from transactions exempt from Section 16(a) in the holdings column of the next otherwise required Form 4 or Form 5 filed to report a transaction in securities of the same class." Release No. 34-46,421.
22. *Id.*
23. Prior to 1991, even in cases in which the grant of a stock option was exempt under Rule 16b-3, the exercise of a stock option was considered a non-exempt purchase and, therefore, reporting persons would be subject to Section 16(b) liability if a sale of the class of stock subject to the option occurred within six months following the exercise. See Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-

11,814, 46 Fed. Reg. 48,147 (Sep. 30, 1981), Q.87. As a result of amendments to the Section 16 rules adopted in 1991 and 1996, exercises of stock options are generally exempt from the short-swing profit provisions of Section 16(b). See Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Release No. 34-28,869, 56 Fed. Reg. 7,242 (Feb. 8, 1991), Section III; Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Release No. 34-37,260, 61 Fed. Reg. 30,376 (May 31, 1996), Section II.E. In addition, following the 1996 rule adoption, the grant of a stock option can also be exempt from Section 16(b) liability if the grant is approved in advance by the company's board of directors, by a committee of two or more non-employee directors (as defined in Rule 16b-3 of the Exchange Act), or by the company's shareholders (shareholders also may ratify the grant no later than the date of the following annual meeting of shareholders). Alternatively, the exemption will apply if the options are held for at least six months or if the combined holding period of the options and the underlying securities received on exercise of the options is at least six months. Release No. 34-37,260, *supra* Section II.D. Therefore, under the current rules, where a stock option grant has been

approved in accordance with Rule 16b-3(d), an officer or director could exercise the option and sell the underlying shares immediately after the grant.

24. Rule 3a12-3(b). The term "foreign private issuer" is defined in Rule 3b-4(c).

25. Release No. 34-46,421.

26. *Id.*

27. *Id.*

28. *Id.*

29. Form 8-K Disclosure of Certain Management Transactions, Release No. 33-8,090, Release No. 34-45,742, 67 Fed. Reg. 19914 (Apr. 12, 2002).

30. Release No. 34-46,421.

31. See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8,106, 67 Fed. Reg. 42,914 (Jun. 17, 2002).